

THE FINANCIAL INSTABILITY HYPOTHESIS
AND
CURRENT COMMON PROBLEMS OF RICH CAPITALIST ECONOMIES

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I. Introduction

As 1994 comes to an end the rich capitalist countries, i.e. the United States, the European Union, Japan and former British Commonwealth Countries such as Canada, Australia and New Zealand need to face up to strikingly similar economic problems. First, and perhaps of primary importance in determining the viability of democracy as it has existed in these countries, is unemployment. During the first forty years or so after the great world wide depression of the 1930's unemployment rates of the level now being experienced even during business cycle expansions would have been signals for an all out effort to expand demand and employment. During the great depression and through the first 25 years or so after the Second World War unemployment such as we now have was interpreted as a sign that the economic system was flawed: today being unemployed is taken as evidence that the training, character or genetic

make up of the unemployed is flawed. The keepers of the keys to monetary and fiscal policy wring their hands in the manner of Uriah Heep as they intone dire warnings of inflation if their presumably anti inflationary but in truth pro unemployment contractionary monetary and fiscal policies are abandoned. As these minions see it, the unemployed are unemployed either because they wish to be or because they are innately deficient. Today unemployment is the fault of the unemployed, not of the market economy.

The period of heightened unemployment has been associated with a decline in the standard of living of a substantial portion of the workers employed in manufacturing, mining and transportation. Not only have price level deflated wages of many decreased but the value of "fringe benefits", such as pensions and employer contributions towards health care insurance, has decreased. This has taken place even as the incomes of the well placed and perhaps well prepared has risen to unprecedented heights: executive compensation packages increase even as firms are mismanaged and managerial failures force wage reductions on workers.

Employment and incomes in what are now called financial services have increased. In many cases the stars in managing other peoples money in pension funds and mutual funds earn incomes that put the publicized incomes of star athletes and entertainers to shame.

Increasingly the financial game has taken the form in which complex combinations of positions are taken in order presumably to protect against income or capital value losses, but which can lead to greatly amplified losses if market developments are "wrong". These instruments, generically called "derivatives", are invented by the personnel of money market Commercial and investment banks.

One result of a chronically closely contained economy is that there are always some firms making large losses. One reaction of such losses is to downsize the firm, which usually means that layers of middle management are removed. The idea of joining a large firm as a junior executive and making a secure career within this firm has all but vanished in the 1990s. This managerial insecurity has cast an oppressive shadow over the operations of firms. A new source of inefficiency in large scale enterprises has come into its own: inefficiency due to a lack of commitment by managerial cadre's to the firms for which they work. The commitment and loyalty which paternalistic firms enjoyed has well nigh disappeared in the face of policies that chronically constrain demand.

As a result of the heightened competition brought about by the combination of constrained demand and the new competitive environment that has resulted from the elimination, by the transportation, communication and calculation revolutions of the past decades, of the natural protection of domestic industries, firms quite quickly have

made huge losses. Furthermore financial institutions in many parts of the advanced world have required refinancing by governments that fear systemic fragility in financial markets that could lead to cascading losses. Even as the melt down of the financial structure during the debt - deflation of 1929 - 1933 recedes in time, fear of another such episode erodes the confidence of even those who have played according to the rules of prudent savings.

The revolution in communication and computation has tied financial markets ever more closely together. Today there are vast pools of money involved in international financial markets: monies which are in international financial markets because of the great expansion of international trade and international investment, of both industrial and portfolio types.

E. Domestic policy actions being dominated by the need to satisfy international financial markets.

C. Fiscal constraint - unwilling or unable to tax even as spending continuous especially commitments for pensions etc increase.

D. Financial losses on a large scale by firms and financial institutions: periodic needs to bail out financial institutions. Fear of a financial catastrophe.

II. The Financial Instability Hypothesis

A. Breaks with the standard approach of first solving for the equilibrium of an exchange economy and then adding

1. production
2. Multi period capital assets
3. Money: In particular goes along with Keynes in "escaping from the Quantity Theory of Money". One implication of such an escape is that the validity of the dominant Economic Theory - the General Equilibrium Theory - is questioned.

B. It is a variety of Keynesian Theory

1. Breaks with the Hicks Hansen ISLM mode of reasoning.

2. Integrates the monetary or financial aspects and the real employment and production aspects of a capitalist economy.

3. Does not assume that the market mechanism if unconstrained will lead to a full employment equilibrium.

4. Is a theory of a capitalist economy: Keynes misnamed his great work. His The General Theory of Employment etc is not a General Theory applicable to all economies, it is a special theory of a capitalist economy which has a complex financial system.

5. It was written as the great collapse of Capitalist economies was taking place.

6. In the United States, between 1929 and 1933, prices and wages fell by 30% and real output fell by 30% so that GDP fell by approximately 50%. However the index of prices on the New York Stock exchange fell by 85 %:

the price levels of land, homes and commercial buildings also fell at least as drastically as stocks.

7. The relation between asset prices and output prices is a special attribute of capitalist economies.

B. The Financial Instability Hypothesis Recognizes that Capitalism changes: among the varieties of capitalism we can identify:

1. According to financial relations

- a. Commercial or Merchant
- b. Industrial
- c. Financial
- d. Managerial
- e. Money manager

2. According to structure

- 1. Laissez - faire
- 2. State Capitalism
- 3. Welfare State
- 4. Solidarityistic
- 5. New Conservative

3. According to reach of Trade and Finance

- 1. National
- 2. Global

III. Capitalism as a Two Price System. (recall In the United States, between 1929 and 1933, prices {the consumer price index} and wages fell by 30% while the index of prices on the New York Stock exchange {the famous Dow Jones Index

or the Standard and Poor's Index} fell by 85 %: the price levels of farms, urban land, homes and commercial buildings also fell at least as drastically as stocks.

A. The prices of current output are a means of recovering costs and carriers of profits.

1. First Floppy: Total costs as a function of output and the prior payment commitments.

2. Second Floppy: transformation of current total costs into a set of average and marginal costs.

3. The speed of wage and other cost adjustments especially contractual debt costs as denominated in money unit are slow.

B. The prices of capital assets and financial Instruments are determined by expected values of attributes of assets. The attributes of assets are

q = expected earnings of assets either by contract as for bonds or as profits as for stocks and companies.

c = carrying costs of assets, which could include the depreciation of assets with time, the costs of storage as well as the interest paid to finance positions in assets. (Thus for a company's physical capital assets the profits are given by the excess of revenues over debts and the carrying costs by the payments that have to be made on bonds and other outstanding debts as stated in contracts. A rise in interest rates may increase carrying costs even as it does not increase the expected returns)

l = liquidity which, for an asset is determined by the assuredness and the cost of exchanging the asset for money.

IV. Attributes of Liquidity.

A. Money is an asset whose price is always 1.

B. The liquidity of assets other than money is a function of the Breath, Depth and Resilience of the markets in which it is traded.

1.. Short term Treasury Securities and non money demand liabilities of banks are the most liquid.

2. Breakdown of markets such as bank failures or stock market breaks increases the subjective value of liquidity.

3. An increase in the subjective value of liquidity leads to a fall in the market price of those assets which are mainly valued because of the incomes they are expected to yield.

4. Once markets appear for equities and other financial markets the change in the prices of such assets can be very rapid: this is especially true on the downside. Such breaks reveal that such financial assets may become illiquid very rapidly.

V. Central Banks as providers of liquidity to first banks and through banks to others who may need to negotiate assets into money either by borrowing or by sale.

A. Central banks are not suppliers of equity funds.

B. Modern capitalist economies may need an in place refinancing agency, a government investment bank: Italian IRRI or American RFC as both refinancing agency or as a venture capital fund.

C. In the absence of a Government investment bank Treasuries often step in and refinance. European common market attempt to set standards for such intervention.

VI. The flow of income is a flow of liquidity.

A. Incomes are the q's (profits) which are capitalized.

B. The determination of profits: the Kalecki, Levy Profit formula;

C. Simple Form: $P = I$

D. Complex Form: Profits = Investment + government deficit + surplus on International Trade account + consumption spending by receivers of capital incomes - savings out of wage incomes. The profit formula is conceptual, difficult to get allocation of profits numbers in a world where there is performance compensation.

Floppy # 3

Floppy # 4. The two prices P_r inv output and price of capital assets: normal functioning $p_k > p_i$

Floppy 5 Leverage ratio Endogenously determined by near or intermediate term success or failure of profits

Hypothesis over a run of good times both borrower's and lender's evaluation of potential outcomes as well as willingness to take risks attenuates.

A striking disappointment of outcomes relative to the expectations of outcomes that are embodied in the liability structure will lead to an increase of both borrower's risk and lender's risk. A heightening and a sustaining of the heightened lender's risk is now called a credit crunch.

VI. The Financial Instability Hypothesis views the financing of investment as the key capitalist act: the key act being the negotiations between the potentially investing business person and the banker.

1. Banker as the designated Sceptic of the capitalist economy, business investors as the designated optimist, cheer leader.

2. In a small government capitalism the weight of the potential deficit in the generation of profits is small. The numerators in the present value formula's can collapse to virtually zero: This implies a potential collapse of asset values.

3. The role of big government in containing business cycles

VII. The closer integration of finance into the explanation of system performance is now a main research frontier. Such an integration of finance leads to the realization that the assertion of optimality to market outcomes was naive. The threats of big depressions and big inflations in a financially complicated capitalist economy are significant. The government budget provided an

effective way to contain such endogenous instability. However even with government success bred complacency as well as a corruption of government.

A new era of relevant government intervention, intervention that is tempered by the acceptance that nothing lasts forever is needed.